

Multinational transfer pricing of intangible assets and tax audit adjustments: Evidence from Indonesia

Introduction

Multinational transfer pricing is considered to be an international instrument of tax strategy and management used by multinational corporations (MNCs) for the purpose of maximizing their profit and minimizing their tax liabilities in the countries where they operate one or more subsidiaries, divisions, or affiliates (Borkowski, 2010). MNCs may choose to exploit differences in tax policies, transfer pricing regulations, import duties, and profit repatriation restrictions, to shift profits from one jurisdiction to another in order to minimize taxes, thus depriving some countries of their proper tax revenues (Borokowski, 1997). Tax auditors are required to carry out rigorous examination and investigation of MNC taxpayers to ensure that the local government receives the appropriate amount of revenue resulting from transfer pricing transactions. However, conducting such an examination is often challenging, as the transactions between the local enterprises and their foreign-related parties do not always obey the *arm's length principle*, since one party has significant influence over the others [Organization for Economic Co-operation and Development (OCED), 2010)].

The purpose of this paper is to provide descriptive evidence on (a) the challenges faced by Indonesian tax auditors during the audit process of intangible property-related multinational transfer pricing cases, and (b) the mechanisms used by Indonesian tax auditors to ensure appropriate tax audit adjustments. We use a qualitative research method involving semi-structured and open-ended interviews with thirteen (13) tax auditors in Indonesia. We also include some Indonesia court decisions pertinent to research question (b) above. To the best of our knowledge prior research on tax audit adjustments for multinational transfer pricing issues has not included court decisions. Mulyani (2010) investigates multinational transfer pricing

problems in Indonesia, but primarily focuses on identifying the factors influencing MNCs' decisions to comply with Indonesian transfer pricing provisions.

In the last decades, Indonesia has attracted overseas investors interested in the country's abundant natural resources, lower cost of production and potential market.¹ Cross border transactions taking place between a parent company and its Indonesian branch or subsidiary increased significantly owing to this remarkable growth in foreign direct investments.² Borkowski (2001) and Li (2005) claim that, following the increase in foreign direct investment, the conflicts between MNCs and tax authorities in both host and home countries amplify, as these MNCs try to reallocate their income from higher tax jurisdictions to lower ones in order to minimise their total tax burden and maximise profit. Moreover, a considerable fiscal problem emerges, since intra-group transfers offer MNCs a substantial chance to decrease taxes, lower the corporate tax base, and discriminate against domestic corporations (Benshalom, 2013). To guard against these risks of expropriation, local tax authorities enforce their legislative and regulatory tools, including tax audit adjustments (Li, 2005).

MNCs transfer pricing activities can be related to transfers of both tangible goods and intangible property, and should be based on the arm's-length principle. All transactions involving intra-company transfers of intangibles must be valued at a price that the MNC would have used when dealing with an external independent entity (OECD, 2010) However, the lack of comparable transfers from which to develop an arm's-length price complicates the valuation

¹ From 2008 to 2012, foreign direct investment inflows to Indonesia increased significantly, from US\$9.32 billion (2008) to US\$19.9 billion (2012) (UNCTAD, 2012).

² Foreign investors, as parent companies, could set up entities in Indonesia in the form of branches or subsidiaries. Another scheme could involve an Indonesian entity acting as a contract manufacturer, purchasing raw materials from its Indonesian-related parties and producing goods based on the order of its head office, or other related parties, located overseas, then sending the finished goods to other countries on behalf of its affiliated enterprises. Yet another scenario could be envisioned where a parent company provides assistance with know-how, management and technical skill to the Indonesian entity and, in return, receives a significant amount of compensation in the form of royalties, technical 'and/or' management fees.

task. This is a serious problem for Indonesian tax authorities to deal with, as there are almost always some key intangible transfers involved. The situation is further complicated by the fact there is lack of legislative enforcement, to transfer pricing regulations, in developing countries including Indonesia. This paper thus considers the challenges encountered by Indonesian tax auditors and related tax authorities in making appropriate tax audit adjustments following the provisions stipulated in the recently enacted Indonesian Income Tax Law and the OECD guidelines. By considering the role of the tax auditors, this paper contributes to the literature addressing multinational transfer pricing and tax audit issues.

The remainder of the paper is structured as follows. The next section reviews the related literature and outlines the difficulties with using the arm's length principle and comparables for valuation and related tax adjustments for multinational transfer pricing of intangible property transactions. Section 3 provides a brief overview of the Indonesian tax regime, pertinent to the research questions to be addressed. Section 4 describes the research methodology used for answering the research questions. Section 5 discusses the main findings. Finally section 6 concludes the paper.

Related literature

An unprecedented increase in cross-border transactions worldwide has led to an increase in the inter-company transfers of intangible property between multinational corporations (Pinto, 2012). Extant research on transfer pricing problems addresses, among others, the transnational transfers of both tangible goods and intangible property, and practical studies of transnational corporate transfer pricing practices [See Borokowski (1996) for a meta-analytic review of the transfer pricing research]. Borokowski (1997) surveyed government authorities in 47 countries to shed light on their respective governmental concerns about transfer pricing, and the need for

regulations to combat transfer pricing manipulation by MNCs. Respondents believed that developing a standardized transfer pricing policy, and mandating increased disclosures about the magnitude and effects of transfer pricing on subsidiary income and tax liabilities in the financial reports of MNCs, would be useful in curtailing transfer pricing manipulation.

The international standard for developing transfer prices for intangible property transferred between or among a parent MNC and its subsidiaries is the arm's-length principle. Its fundamental goal is to ensure that arrangements undertaken between affiliated enterprises are at least similar to those conducted by independent enterprises in a perfectly competitive environment. When conditions between affiliated enterprises differ from those of independent enterprises, tax authorities are granted power to adjust profits earned by those affiliated enterprises, based on Article 9 (2) OECD Model Tax Convention (Pogorelova, 2009).

The OECD points out that when independent parties conduct a transaction, market forces will define the conditions of both commercial and financial relations, such as the price and condition of goods and services being transferred. On the other hand, when associated enterprises are involved in transactions with each other, external market forces might not influence those transactions. This creates concerns, as prices and profits might be set up to favour associated enterprises and, as a result, the tax revenue of host countries could be distorted (OECD, 2010). Although the arm's-length principle has been adopted as an international standard for settling transfer pricing cases (Borokowski, 2001), Falcao (2010) claims that finding appropriate comparable transactions under comparable circumstances is very demanding, especially in developing countries, as they do not have enough ability to produce goods and services that would supply the data required to develop comparable benchmarks. They might import benchmarks from developed countries such as the US, UK or Japan, but application

problems will arise owing to the differences in supply and demand, market and business conditions in transactions between related parties in developed and developing countries.

Pinto (2012) compares differences in the transfer pricing practices between Canada and China and concludes that the choice of transfer pricing practices in a country is dependent on its economic development, and its culture, political and economic systems, therefore, making the global transfer pricing guidelines issued by the OECD less relevant. Pinto (2012) also highlights that when the transfer of intangible property takes place between associated enterprises, valuation issues arise, as it is very difficult to find comparable prices because the intangible property is frequently self-developed by the associated enterprises, is frequently exclusive to the groups, and is not transferred to the independent parties.

Visconti (2012) argues that the tax treatment of transfer pricing of intangibles has become one of the most important international tax concerns. The application of the comparable uncontrolled transaction (CUT) principle introduced by the OECD may create problems with intangible property, since such transactions are usually negotiated within international groups. Well-known trademarks or patents usually belong to big companies, so it seems complicated and often meaningless when their transactions are compared to those of smaller and uncontrolled negotiations. Another complexity is presented when entities within a multinational group develop intangibles by joint efforts and then use those intangibles, regardless of their involvement in the initial development. These facts make the task of separating and allocating the relative involvement of each group member within a multinational group a burdensome and inaccurate exercise (Przysuski, Lalapet and Swaneveld, 2004).

Although multinational transfer pricing, and related tax audit complexities, have been identified as having more serious consequences for developing countries, there is, a dearth of

research evidence on MNC transfer pricing problems. Borokowski (1997) surveyed government authorities from 47 countries, but did not investigate tax auditors' concerns regarding multinational transfer pricing manipulations. However, Mulyani (2010) is a more recent study on transfer pricing compliance by MNCs in Indonesia that used surveys and semi-structured interviews in 2008 to investigate the problems associated with tax compliance. In contrast the primary purpose of the current study is to investigate Indonesian tax auditors perceptions of their audit objectives.

Brief overview of Indonesian tax regime

According to the Law on General Provisions and Tax Procedures, Indonesia adopts a self-assessment system so that taxpayers are granted the right to define, calculate, and pay their own taxes. However, the Director General of Taxes has the authority to conduct an audit to test compliance of the taxpayers, and for other purposes in respect of implementation of the tax Law. Refund audit is among the top priorities of the tax authorities, and transfer pricing cases are an important component of refund claim audit, or audit for other purposes (Mulyani 2010). Tax auditors are responsible for ensuring that the government receives an appropriate amount of revenue resulting from transfer pricing transactions. They are granted rights by the tax laws and regulations to carry out rigorous examination and investigation of taxpayers. For this reason, they might make appropriate adjustments to multinational transfer pricing cases after obtaining sufficient evidence in support of the adjustments.

Transfer pricing provisions are stipulated in Article 18 of the new Indonesian Income Tax Law which took effect from 1 January 2009. These provisions require taxpayers conducting affiliated transactions to adopt the arm's length principle. To apply it , taxpayers are obliged to

undertake comparability analysis, determine comparable transactions and provide transfer pricing documentation (EY, 2013). The Directorate General of Taxes is granted the authority to adjust and redistribute taxable income and expenses of related parties, so that transactions between affiliated parties are treated as those of independent parties (Article 18, paragraph 3 of the Income Tax Law Number 17 of 2000). The term *related taxpayer* is explained further in paragraph 4 of the same document as follows:

- a. A taxpayer who owns directly or indirectly at least 25% of the equity of other taxpayers; a relationship between a taxpayer through ownership of at least 25% of the equity of two or more taxpayers, as well as a relationship between two or more taxpayers concerned;
- b. A taxpayer who controls other taxpayers; or two or more taxpayers directly or indirectly under the same control;
- c. A family relationship either through blood or through marriage within one degree of direct or indirect lineage.

Usually, during the audit process, taxpayers and tax auditors have an opportunity to discuss the audit findings. A potential dispute occurs when they fail to reach a consensus regarding the amount of tax payable. In most transfer pricing cases, tax audits end up in disputes in which taxpayers have the right to submit objections to the relevant regional district tax office or to the Directorate of Tax Objections and Appeals. If taxpayers are still not satisfied with the tax office's decision on their objections, they have the right to submit an appeal to the tax court which is an independent party of The Directorate General of Taxes. If taxpayers win the case, and if they had already paid the additional tax imposed on them by the Indonesian Tax Authorities (ITA), the Government has an obligation to pay back that amount, plus interest of 2% per month, for a maximum of 24 months.

At the same time, taxpayers are also granted the right to request a Mutual Agreement Procedure (MAP) with a competent authority in the country of a related party having a tax treaty with Indonesia, as stipulated in Government Regulation Number 74/2011. Therefore, taxpayers are allowed to apply for an MAP simultaneously with any objection or request for reduction to an incorrect tax assessment made by the Indonesian Tax Authority (ITA), or appeal to the Indonesian Tax Court (KPMG, 2012). Settlement of transfer pricing disputes is very difficult, and a considerable time is needed for each of the processes of objection and appeal. In addition, it might take many rounds of bilateral negotiations between the Competent Authority of Indonesia and her counterparts, during which significant resources are consumed.

Navarro and Mukanov (2012) claim that the ITA give more attention to transfer pricing cases because there has been a significant increase in related party transactions, as many investors have set up businesses in Indonesia. They highlight that Indonesian transfer pricing regulations are stipulated in Article 18, paragraph (4), of the 1983 Income Tax Law. Moreover, in 2008, the Indonesian Parliament enacted regulations requiring taxpayers to maintain all documentation for related-party transactions. Armed with these resources, the ITA started conducting aggressive transfer pricing audits from the beginning of 2009. Royalty and service transactions were the first target of these audits, which resulted in considerable tax adjustments, since the Indonesian companies involved in related party transactions with foreign companies were unprepared, and incapable of demonstrating the use of intangible property and services or the benefits that they might enjoy from them. The audits changed transfer pricing practices in Indonesia, and forced international companies operating in the country to better administer their intra-group transactions.

Moreover in 2010 the ITA enacted the first comprehensive transfer pricing regulations in 2010, which adopted the arm's length principle for settling tax disputes involving intangibles and replaced the common business practice (benchmark derived from industry norms and practices) approach for finding comparables (Navarro and Mukanov 2012). In general, this regulation follows the 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. With regard to documenting the utilization of services, taxpayers were to provide related documentation to demonstrate that services had been rendered and that those services 'add value' to the recipients, in economic or commercial terms. For royalty payments, the new regulation defines and elaborates further on intangible properties such as patents, copyrights, trademarks, trade intangibles and marketing intangibles, so that taxpayers have a legal basis to characterise royalty transactions.

Research methods

To derive descriptive evidence about the difficulties associated with tax audit adjustments and the mechanisms for overcoming those difficulties, a semi-structured interview which followed predetermined guidance was utilized to interview the tax auditors involved in the aforementioned cases (Appendix 1 contains the indicative questions used for the interviews). This semi-structured approach was selected to fulfil the research objective and to allow flexibility to respond to participants' replies and follow-up on emerging issues (Bryman and Bell, 2011). In addition, for corroboratory purposes, an open-ended interview was conducted with the persons in charge at the Directorate of Tax Audits and the Directorate of Tax Regulations II. The open-ended method was applied in this instance because the interviewees are policy makers, and the questions they would be asked were related to their insight on transfer pricing regulations and management (Bryman & Bell, 2011).

The prospective respondents were provided with a Participant Information Sheet and were given five working days to consider whether to take part in the research. Of the sixteen prospective candidates, thirteen participated in the interviews, one declined for health reasons, and two could not be contacted further. Nine of the thirteen respondents hold masters and/or doctor's degrees. The group as a whole was very experienced with nine in service for more than 20 years and none for less than ten. The interviews were conducted in *Bahasa* Indonesia, the official language, and were recorded with the consent of participants. Transcription of the interview results was done by a professional transcriber. The transcription and data analysis were conducted in *Bahasa* Indonesia. Interviews lasted for a half to one hour. For respondent validation purposes, the transcriptions were sent by the researcher to the participants for approval. After the transcriptions were validated by the respondents, data analysis was conducted in *Bahasa* Indonesia. Thematic analysis, "*a method for identifying, analysing, and reporting patterns (themes) within data*" (Braun & Clarke, 2006, p.79), was used to analyze data. This approach demonstrated an effective tool for formulating the research questions and summarizing key characteristics and significant differences across the data set (Attride-Stirling, 2001; Smythe & Nikolai, 2002; Braun & Clarke, 2006). Initial codes were assigned at the end of the reading process for each quotation. This generated 863 initial codes, along with initial code references. The next phase identified forty two themes which address the two central research questions:

1. What difficulties do Indonesian tax auditors encounter in auditing intangible property issues in multinational transfer pricing cases? and
2. What mechanisms do Indonesian auditors use to deal with transfer pricing adjustments involving intangible property?

In order to achieve coherent constructions, themes were reconsidered when coding process of the data was done and a repeat reading of the extract data for each theme was undertaken. If coherent construction was obtained, an individual theme would have been identified. The validity of the theme and the accuracy of thematic map were compared to the whole data set (Braun & Clarke, 2006). This step identified forty two potential themes which were then grouped into thirteen themes along with their subthemes (see following section for discussion). The relevant quotations were then translated into English, and were classified, based on themes, along with quotation numbers from each participant, so that it would be easier to trace issues to the original transcripts later on.

Results and Discussion

This section presents the findings for the two research questions which address from a transfer pricing perspective the difficulties faced by Indonesian auditors related to intangibles and the mechanisms used to deal with the required audit adjustments. The thematic analysis revealed nine relevant themes. Four address the audit difficulties raised by question 1. They arise from

- Technical matters of tax audits
- Accounting transparency and lack of cooperation
- Current regulations
- Organization of the Directorate General of Taxes and Human Resources

Five themes relate to the audit adjustment mechanisms examined in question 2.

- Legal basis for referencing audits
- Role of tax auditors

- Role of Head of District Tax Office (DTO) and Head Office of Directorate General of Taxes (DGT)
- Collaboration among Directorate of Tax Audit and Collections, the Directorate of Tax Regulations II and the Directorate of tax Objections and Appeals
- Role of Account Representative

Difficulties Faced by the Indonesian Tax Auditors during Audit of Transfer Pricing Cases Derived from Intangible Property

The first relevant problem faced by tax auditors is to determine whether an intangible transaction has occurred. This problem becomes more complicated when an intangible transaction takes place among affiliated parties. Seven respondents shared the view that determining the existence of intangible transactions was among the first and/or most difficult problems in dealing with this kind of transaction.

The first thing that needs to be proved is the existence of intangible property, something that is intangible must be proved, whether it exists or not. Moreover, those transactions are conducted between affiliated parties, because they are not independent, but inter-affiliate, then something that does not exist, could be deemed to exist (R4).

Since the characteristics of services and intangible property are quite similar, tax auditors have difficulty defining intangible property transactions, differentiating between intangible property and services, and classifying types of intangible property. This problem is in line with Visconti's (2012) claim that since the characteristics of intangibles are difficult to isolate and may overlap, tax auditors might have difficulty in differentiating one type of intangible property from another as well as in differentiating between intangibles and services.

Four respondents mentioned that finding comparables is a problem for tax auditors during the audits of intangible transactions. This difficulty is amplified, since intangible transactions are

carried out between related parties with contractual terms and economic conditions rarely similar to those in independent relationships. Vidal (2009) claims that finding comparables for intra-group transactions undertaken by multinational enterprises is challenging because multinational enterprises generate profit owing to their uniqueness as well as to market imperfections. Moreover, Pinto (2012) highlights that since intangible property is often self-developed by these associated enterprises, it is frequently exclusive to the groups, and is not transferable to independent parties. One respondent explained as follows:

...the characteristics of the goods or services; the function of assets and risks; the contractual terms; business strategy; and economic conditions...can affect the price of the transaction.... intangible property is abstract, so it is difficult to conduct assessments or measurements. In addition...intangible assets should have a unique value, and a unique value will have unique characteristics, so finding its comparison is very difficult...and that is the main difficulty.. (R4).

Six respondents mentioned that determining the arm's length value of intangible property is also a difficult problem, owing to its abstract features and the challenge in finding comparables. The difficulty in finding the arm's length value of intangible property has drawn the attention of many scholars. Pinto (2012) argues that valuation is a major issue in the examination of transfer pricing due to the difficulty in finding appropriate comparables. Further, Visconti (2012) claims that valuation is one of the central issues in intangible property because it has immaterial features which are abstract, and no active markets exist for this kind of property. In addition, he argues that this difficulty in valuation results from different methods adopted by multinational enterprises when assessing the value of intangible property. Moreover, the complexity of such a valuation exists because it is frequently embedded with other physical assets when transferred to company affiliates (Przysuski et al., 2004).

Respondents also raised concern regarding the difficulty of verifying the transfer of intangible property; and determining its benefits and entitlements. Verifying the transfer of intangible property from the parent, owner, or developer of the intangible property to a subsidiary or licensee is one of the requirements that needs to be fulfilled. However, to do so is challenging for tax auditors, because it is different from the transfer of tangible property, which is quite easily verified. Tax auditors also face a challenge in defining the party who owns intangible property since the real owner sometimes moves to another lower-tax jurisdiction.

As reported by one respondent, tax auditors often face a problem understanding taxpayers' bookkeeping, because taxpayers create sophisticated techniques that obscure transactions undertaken. This is exacerbated when taxpayers refuse to disclose the relevant information unless approval from headquarters is obtained:

Indeed, it [XCo] has a closed bookkeeping and accounting system; they have so many codes and no descriptions. A chart of accounts exists, but there is no description; we didn't know what the codes on these accounts were for. When we requested to open the codes they said that permission from its headquarters must be obtained (R1).

Thematic analysis has identified two issues with regards to current regulations: namely, workload pressures and limited time for the completion of audits, especially tax refund audits; and transfer pricing regulations that are too loose and lack detail. Six respondents mentioned that large workloads resulting from routine audits for tax refunds put an excessive burden on tax auditors, so that less time could be dedicated to transfer pricing cases. The Indonesian regulations require every tax refund claim submitted by taxpayers to be audited. The time limit for completion of this kind of audit is one year, starting from the day the tax return is submitted. The burden on tax auditors increases when transfer pricing cases take place along with refund claims.

Tax audits for intangibles are complicated because it is impossible to conduct an in-depth analysis in only one or two days, and rigorous research and much evidence are needed. Time is restricted, because for example, if the case falls under the requirements for a tax refund claim audit, then it is very difficult to cover transfer pricing audits properly (R5).

But the main reason is actually because of workload. One audit team could get 100 assignment letters. So, they do not have any chance to manage transfer pricing, which involves a lengthy procedure....We make a broad analysis first to learn the character of the business for transfer pricing, complete a FAR analysis, and search for comparables. It takes a long time, so many tax auditors give up (R9).

Other concerns raised suggested that the current regulations dealing with transfer pricing were too loose and not detailed enough, making it very difficult to prove that transactions conducted by related parties are not in accordance with arm's length conditions. This might be attributed to the fact that Indonesian transfer pricing rules and regulations are relatively new and fail to address every case.

One of the most significant problems related to organization and human resources appear to be the existing rotation system. Different interests between the Directorate of Tax Audits and Collections and the Human Resource Division leads to conflict in the rotation of tax auditors. The Human Resource Division policy is that the rotation system should be nationally based, so that every tax auditor should move from one district tax office to another within the territory of the Republic of Indonesia, while the Director of Tax Audits and Collections would like to make exceptions for tax auditors whose expertise is in transfer pricing, because these are most needed in certain regional tax offices, such as the Special Regional Office and the Regional Office for Large Taxpayers. Two respondents highlighted problems related to the rotation system. One expressed this as follows:

Sometimes there are conflicts, the interests of the Directorate of Tax Audits and Collections are different from those of the Human Resource Division. Actually, the Director of Tax Audits and Collections is already aware that rotation for auditors must be nationwide for turn purposes but the skilled persons should get exceptions (R1).

In order to handle transfer pricing cases properly, experienced tax auditors are required. However, with the current rotation system, the most knowledgeable tax auditors may not always be working on the most difficult cases. It can take a long time to train new tax auditors to handle transfer pricing cases, and this puts the audit team and the organization as a whole at a disadvantage.

Furthermore, the Directorate General of Taxes does not have any tax auditors especially dedicated to handling transfer pricing cases, and they are only of ‘echelon four’ status in the organizational structure. Thus, as the number of transfer pricing cases has recently increased, without any changes to current organizational structure, burdens on tax auditors and the Directorate General of Taxes will have increased significantly. This is further exacerbated by the fact that the general competency level of tax auditors is quite low as transfer pricing cases in Indonesia only take place in certain regional tax offices.

Ways Indonesian Tax Auditors and Officials Deal with Transfer Pricing Cases Derived from Intangible Assets

Tax auditors use Article 18 paragraph (3) of the Income Tax Law as a legal basis and starting point to conduct analyses and evaluations of related party transactions. This Article provides an entry point to conduct further investigations once a related party is deemed to exist.

Eight respondents mentioned this in their interviews:

Related-party relationships are defined in Article 18 paragraph 3 of the Income Tax Law, so with the authority of this article we decide that certain related-party transactions need to be explored more. In principal, Article 18 paragraph 3 provides the key and entry gate. If a related-party relationship exists, then it must be examined further (R1).

Once tax auditors have enough evidence and reach a conclusion that intangible property transactions are not in accordance with the arm’s length principle, they use Article 18 to make

positive adjustments to these affiliated transactions. Five respondents believe that contracts between associated enterprises would be respected as legal documents, but affirmed that these contracts would be compared to the facts of the taxpayers' transactions. Two respondents elaborated further on their treatment of contracts between affiliated enterprises stating that they conducted a directed investigation of the production processes and compared the results with those described in the agreement.

Tax auditors also refer to the OECD Transfer Pricing Guidelines if they cannot find any references pertinent to their cases in domestic legislation and tax treaties. Four respondents mentioned that these guidelines are important references for both transfer pricing regulation and audits. However, the tax auditors are not allowed to use the OECD Guidelines as a legal basis to make positive adjustment to the affiliated transactions. The legal basis must be the domestic legislation. The OECD can serve as guidance to find fairness or arm's length comparables for affiliated transactions only.

Yes, but it is not allowed. So, the legal basis for making positive adjustments are still our laws and regulations. If only for an argument, that's OK. The argument of fairness could be obtained from anywhere but the legal basis for making positive adjustments is still Article 18 paragraph 3 (R9).

Borkowski (2001) points out that certain countries might use the OECD Transfer Pricing Guidelines as a reference in developing their own transfer pricing regulations. In addition, the application of these transfer pricing guidelines varies from one country to another owing to differences in traditions, politics, economics, and legal systems (Pinto, 2012).

These experiences were confirmed by the Indonesian Tax Court's decisions on intangible disputes between the Indonesian Tax Authority and PT. L'Oreal Indonesia. According to the "license agreement" between L'Oreal SA and PT. L'Oreal Indonesia, L'Oreal SA grants to the licensee the exclusive right to use the "technology" and the "licensed trademarks" and to

distribute and sell the licensed products in the territory and the right to market the licensed products, including the exclusive right to exploit the licensed patents. In return, PT. L'Oreal Indonesia shall pay royalties to L'Oreal S.A. France based on the proportion of the net sales of the licensed products which was determined to be 5% for the use of technology and 1% for the use of licensed trademarks. Tax auditors concluded that royalties would accrue only if PT. L'Oreal Indonesia has used 'technology' and 'licensed trademarks' owned by L'Oreal SA France. However, Tax auditors claimed that based on audit results it was found that during 2005, PT L'Oreal Indonesia never produced a 'licensed product' owned by L'Oreal SA, France so that royalties invoiced by L'Oreal SA France were not in accordance with the arm's length condition. This non-arms length condition could take place because L'Oreal S.A. France and PT. L'Oreal Indonesia were related parties in which 99% of the shares of the former were owned by L'Oreal S.A. France. Thus, tax auditors made positive adjustments to the royalty payments and reclassified the payment into dividend payments (profit sharing). All of the royalty expenses reported by PT. L'Oreal Indonesia in its income tax return were adjusted by tax auditors to nil.

Interview evidence reveals that tax auditors try to play an active role in making tax audit adjustments by conducting FAR (functions, assets, risks) analysis in order to define the need for specific intangible property transactions in certain industries. Tax auditors also consider the nature of business in industries in which taxpayers operate. If it is generally accepted that an intangible transaction is a necessity in operating the business of a taxpayer, then this typical payment is accepted as a deductible expense by tax auditors. However, for example, if a company serves only as a contract manufacturer, then tax auditors might conclude that any payment related to royalties paid to its principal will be subject to positive adjustment. If the

principal argues that such royalty payments belong to other parties, the judgment of the auditors is still based on the functions performed by the subsidiary.

One respondent shared his experiences of conducting rigorous financial statement analysis, and of trying to figure out key issues such as How can a company with its main business in delivering services suffer losses for such a long time? As corporate income tax in Indonesia is paid only on profits, the company did not pay income taxes for a considerable time.

We had been suspicious of XCo from the very beginning, and they didn't pay income tax for ten years due to continuous loss. They would offer their price to clients with a 40% discount but they paid rent to their group at 100% of the rental expense. Is that logical? If the cost is paid to a third party it could be OK, it may be partly at risk of market penetration but if all of the transactions from the group, it becomes so weird, rental from the group, technical assistance from the group. What does it mean? Purposely made to be loss? (R1).

One respondent mentioned that one in-depth analysis ended up with the critical question How can a distributor company pay royalties for the goods they sell from their principal? They found cases where a subsidiary serving as distributor in their normal business would book profit, but with expenses paid to its principal. The subsidiary then appeared to suffer a loss. Tax auditors conducted an analysis on cost of goods sold, which resulted in a very low gross profit margin (3%) while, if the expenses paid to its parent were added back, the company would book significant profit.

If someone becomes a car dealer, they would get a fee, wouldn't they? Expect a profit. They would sell enough cars to receive a certain amount of bonuses. However, in this case, why do we [distributors] have to pay? This is a related-party relationship. Were the related-party relationship absent, is there anyone who would like to pay? We try to calculate the costs of goods sold. The gross profit is only 3%, the bottom line is loss. If this [payment to its parent] was taken out, the company would show a profit. So, if the company is [in] a normal business with no frills, it is running well (R3).

The efforts of tax auditors to scrutinize and investigate audit reports of taxpayers are found by the Indonesian Tax Court's decisions on intangible disputes between the Indonesian

Tax Authority and PT. Ford Motor Indonesia. Tax auditors concluded that payment of distribution right fee to its parent was too excessive causing loss to the subsidiary in Indonesia which accounted for 8.89% of the net sales and 60% of the general and administrative expenses. If the existing cost of goods sold was combined with the expenses paid to its affiliate overseas, such as distribution right fees, management fees, and global marketing fees, gross profit to maintain other general and administrative would have been a mere 3.46% of the net sales of IDR1.26 trillion. A distribution right fee was charged because PT Ford Motor Indonesia was granted an exclusive right by its principal to market car products with the trade names of Ford, Volvo and Mazda in the territory of Indonesia. Tax auditors made a positive adjustment to that distribution right fee expense paid by PT. Ford Motor Indonesia to its affiliates because they were of the opinion that the distribution right fee caused harm to PT. Ford Motor Indonesia and was not an arm's length condition. They claimed that PT Ford Motor Indonesia should get fees or revenues for the services being conducted in order to market the product (car) of its principal located overseas, not the other way around.

With regard to registered intangible property, such as brands and patents, tax auditors claim that proving their existence is relatively easy, since the tax auditors could ask taxpayers to provide the relevant registration with the Directorate of Intellectual Property Rights in Indonesia and other legal documents. However, for non-registered intangible property, tax auditors put more emphasis on non-documentary evidence rather than legal documents, since legal documents sometimes differ from what is actually taking place in the business of taxpayers. Non-documentary evidence could be represented by factual evidence with economic value. Tax auditors go directly to the place where the intangible property is claimed to be used by the taxpayer, conduct observations and interviews of the person in charge of the intangible property

and his supervisor and have the official reports signed by both of them. Two respondents claimed that non-documentary evidence is more important than documentary evidence. One respondent shared his view as follows:

Basically [tax auditors are] looking for factual evidence that has economic value. So, [tax auditors] go to the production division, conduct an interview with the production division, directly observe that production process and ask which part of the production process uses IP [Intangible Property]? We ask for an explanation from the taxpayers and ask them to make an official report and produce testimony given by competent persons. Usually [we] ask for two, one from the production department and one from its chief, who is responsible for the statement made by the production division (R4).

Some argue that since the burden of proof lies with taxpayers to submit transfer pricing documentation, the role of tax auditors in proving the existence of intangible property is to criticize and evaluate the information provided. When taxpayers fail to provide evidence of existence of their intangible assets, tax auditors will propose a positive adjustment for the entire amount of the related transactions.

The efforts of tax auditors in searching evidence for the existence of intangible transactions were observed in the Indonesian Tax Court's decisions on intangible disputes between the Indonesian Tax Authority and PT. Halliburton Indonesia. Tax auditors conducted further investigations on invoices for the technical assistance fee with a total amount of US\$3,324,792 and the royalty expense with a total amount of US\$26,196. It was found that those expenses were invoiced from Halliburton Energy Services Inc. for performing special projects. The audit report refers to Halliburton Energy Services Inc. as a majority shareholder of PT. Halliburton Indonesia (80%), so that a related-party relationship between the two companies exists. Tax auditors, using the authority of Article 18 paragraph (3) and paragraph (4) of the Income Tax Law, claimed that the validity of the transactions between the two above-mentioned

companies was in question and no real work was performed, so that positive adjustments were made for both the technical assistance fee and royalty expenses.

One of the most challenging tasks is to find comparables for intangible transactions. The interview responses revealed that the tax auditors try to find similar cases through internet research, and to determine if affiliated parties honor signed agreements. They also seek to identify internal comparables, for example, licensing intangibles to both independent and related. However, finding internal comparables is very demanding owing to the secrecy issue. Multinational enterprises prefer to grant their license to affiliates, so that they have full control over them. Intangible property is a secret, and the heart of success in their business, as is illustrated by the following respondent:

The OECD also prefers internal comparables [when] a parent company grants a licence to another company so that the licence is granted to the independent party and its affiliates. [However] I have not found such a case yet. Usually, for multinational enterprises, they are a bit reluctant to grant a licence to an independent party. Multinational enterprises feel more secure licensing to their affiliates in order to protect their secrets (R9).

If internal comparables are not available, tax auditors will look to external comparables for each type of intangible property, such as trademarks, patents, know-how, or trade secrets. Because they have their own characteristics, each of them must be registered with the Directorate of Intellectual and Property Rights, Ministry of Law and Human Rights. If they are combined, the reliability of the comparable will be lower. However, since the typical contract for intangible transactions that took place in Indonesia covered all types of intangible, finding external comparables was difficult. To deal with this issue, tax auditors to have adopted the 25% rule of thumb in which royalty payments are deemed in accordance with the arm's length principle as long as they do not exceed 25% of the operating profits before royalties.

To find external comparables, we need to differentiate what kind of intangible that taxpayer has? Trademark, patent, know-how, or trade secrets? This needs to be determined first

because each type of intangible property has its own characteristic. Therefore, we look for external comparisons for each type of intangible. They cannot be combined because it will lower the reliability of the comparative results later on. That is what makes it difficult, and ultimately a practical solution was found by the application of the 25% rule or rule of thumb: the royalty is paid for a maximum of 25% of the operating profits before royalties (R5).³

The tax auditors have different approaches to arrive at arm's length prices for Intangible Property (IP). The OECD Transfer Pricing Guidelines (2010) classify transfer pricing methodologies into transaction-based and profit-based categories. The traditional transaction methods are based on the principle that the true taxable profit of associated enterprises is calculated based on their past transactions to produce an arm's length price. The transactional profit methods are based on the principle that the profits of associated enterprises can indicate whether the transactions between those associated enterprises are at arm's length. The former consists of the comparable uncontrolled transaction (CUT) method; the resale price method (RPM); and the cost plus method. The transactional profit-based measures include the profit split method; and the transactional net margin method (TNMM). For routine IP, tax auditors use the CUT approach to look at other licensees from similar companies in the same industries, while for IP with unique value, the tax auditors will use the Profit Split Method. Other tax auditors use the TNMM approach: an aggregate approach (company-based at the level of net operating margin). TNMM serves as a second opinion to strengthen the CUT Method. Four respondents shared their opinions regarding methods being used to find arm's length values for intangible transactions.

³ The experience shared by this respondent was supported by existing literature reviews. The OECD (2010) claims that a bundle or package contract of intangible properties may include patents, trademarks, trade secrets and know-how in one package. The OECD recommends that the packages should be broken down to their individual components so that the arm's length nature of the transfer of intangible can be verified. However, Visconti (2012) argues that when sold or licensed in package or bundle contracts, the valuation of intangible properties becomes more complicated and challenging and may encourage tax auditors to opt for a rule-of-thumb approach described above.

When tax auditors can confirm that intangible property exists, the next step is to determine the fair value. The method being used is the comparable uncontrolled transaction. Then in addition to the CUT method, we also try to search for the aggregate basis. This [CUT] has a transaction-to-transaction [basis]. We try to find a comparison from the company's point of view, so we use the TNMM. What's the Profit Level Indicator (PLI) of their performance? We use the aggregate basis at the level of the net operating margin (R6).

The experience from Indonesian tax auditors in utilizing transfer pricing methods for intangible transactions parallels the recommendations from the OECD, especially for the profit split method. The OECD (2010) recommends that for the sale or license of intangible property, the CUT method could be applied if an owner of intangible property has transferred or licensed the intangible property to both independent and affiliated enterprises under comparable conditions. The resale price method could be applied to cases in which affiliated enterprises enter sub-license agreements with independent enterprises. The profit split method could be applied to highly valuable intangible property, since it is very complicated to find comparable transactions under comparable conditions for this kind of situation. Traditional methods and the transactional net margin method are difficult to apply in such settings.

Two respondents mentioned the need to prove a transfer of intangible property. Without such evidence, tax auditors will make positive adjustments to intangible property transactions. One of them argued as follows:

...we ask for proof. For example, to produce paint, the producer must use a certain formula. We have to look for evidence of the delivery of the formula either via email or through people who explain the technology to the user (R4).

The tax auditors will try to find the party that is entitled to the benefit of the intellectual property (IP) by scrutinizing the documents of the IP developer, such as development and financial reports, , an employee list and asset inventory. . Tax auditors claimed that the intellectual property developer should have the requisite expertise and capital.

With regards to the entitlement, we usually conduct an assessment of the party who should receive the payment. So, we usually ask for reports of IP development activities, a list of employees working with that IP, asset lists, and financial reports if necessary. The bottom line is any activity that could convince us that the party is reasonable enough to be considered as the IP developer. If the party can develop IP, it means that they must have employees, and the employees must be experts in their fields. Then, they must have money. Nowadays, IP can be subcontracted for its development, but at least they should have the money (R4).

The tax auditors' stand on entitlement is in line with economic ownership view that income from intangible property belongs to the entity which bears the economic costs and risks in the development of the intangible (Przysuski et al., 2004b).

Tax auditors also get support from the Head of the DTO who reviews the audit work and make necessary corrections to improve it. Also during the audit, they provide directions and investigate the taxpayer being audited along with the tax auditors. The head office conducts productive discussions with tax auditors about the nature of business of affiliated distributors, which represent the majority of taxpayers in the Foreign Investment District Tax Office. The head of the DTO plays a crucial role in clarifying the nature of the transactions and tax auditors are required to conduct audit for maximization of tax revenue for the Government of Indonesia. The Directorate of Tax Audits and Collections offers continuous training programs to increase the skills of tax auditors. One of the four respondents explained as follows:

Formally through our human resources division we invite [tax] auditors to have training because they are in direct contact with the case, especially in the Large Tax Office and Special Offices. We try to help our friends [tax auditors] with any technical assistance in completing their working papers for related-party relationships, affiliate details, affiliate transaction schemes, industry analysis, supply change, FAR analysis, comparables (R6).

The Directorate of Tax Audits and Collections provides assistance to tax auditors when they face difficulties in handling transfer pricing cases from intangible transactions.⁴ This assistance is voluntary so that only tax auditors who need help will come for consultation. The assistance covers guidance in completing working papers with regard to related-party relationships, affiliate details, affiliate transaction schemes, industry analysis, supply change, FAR analysis, comparables, and other relevant issues.

The Directorate of Tax Regulations II coordinates the development of transfer pricing regulations with the Directorate of Tax Audits and Collections. The Directorate of Tax Regulations II provides general guidance on transfer pricing, while the Directorate of Tax Audits and Collections is responsible for making policy guidelines for auditing transfer pricing cases. Five respondents discussed how to handle the relevant rules and regulations. Three expressed their ideas as follows:

We [Directorate of Tax Regulations II] coordinate with the Directorate of Tax Audits and Collections on drafting the regulations, and we discuss with them about what things need to be regulated in Indonesia because [they] have more practice in the field. (R7).

The Directorate of Tax Audits and Collections, according to Mr.T, is not allowed to regulate 'material', they can only regulate 'formal'. The domain of the 'material' belongs to the Directorate of Tax Regulations II (R9).

We [Directorate of Tax Regulations II] provide general guidance on transfer pricing. This will be relied upon by the Directorate of Tax Audits and Collections to make policy guidelines for auditing transfer pricing cases (R12).

The Directorate of Objections and Appeals evaluates audit outcomes and sends the results to the Directorate of Tax Audits and Collections. If the decision is in favour of the Directorate General of Taxes, it will be shared with the tax auditors as a reference when they face similar cases. If the Directorate General of Taxes loses the case, the Directorate of Tax Audits and

⁴ The Directorate of Tax Audits and Collections manages transfer pricing cases from the headquarters of the Directorate General of Taxes. However only cases reported to them are monitored. In addition, a regulation was also released to handle transfer pricing cases at regional tax office level, but only in the Large Taxpayers Regional Office, where there is an expert dealing with transfer pricing cases.

Collections will conduct an evaluation of the case and inform the tax auditors of the reasons they lost.. The Directorate of Tax Objections and Appeals also coordinates the review of tax court decisions unfavorable to the Indonesian tax authorities with the Directorate of Tax Audit and Collections.

Account representatives support tax auditors by providing data and in-depth analysis on transfer pricing cases before taxpayers are officially audited by tax auditors. One respondent mentioned the role of account representatives in dealing with transfer pricing cases.

The taxpayers that are not audited will fall under the responsibility of the account representative. We propose that account representatives should conduct analyses, so that special audits can be proposed and semi-finished, and steps of functional analyses are required outside the audit term. Cooperation between account representatives and auditors is needed. I ask if there is data and so on to [pass to] the functional [tax auditors].

Account representatives are responsible for non-refund taxpayers who have transfer pricing transactions that are not yet audited. They conduct in-depth analyses on tax returns submitted by taxpayers before proposing special audits for those involved in transfer pricing transactions. Any data gathered by account representatives needs to be delivered to tax auditors for further investigation.

Concluding remarks

Tax administrations around the world have identified that transfer pricing is a significant issue to address, as they struggle to maintain tax revenue derived from multinational enterprises conducting business in their countries. Transactions between affiliated companies create concerns that prices and profits might favor interests of associated enterprises and, as a result, the tax revenue of host countries could be distorted. The task is further complicated by the difficulties in

finding comparable transactions under comparable circumstances. Also the bilateral negotiations that often occur between competent authorities result in significant resource outlays..

This paper uses semi-structured interviews of Indonesian tax auditors to address two relevant research questions about intangibles related transfer pricing cases. The first question explored the audit challenges associated with transfer pricing cases. The results revealed that some of the problems relate to the technical aspects of tax audits such as finding appropriate comparables for intangible property transactions and determining their fair market value.. Additional issues arise from lack of transparency of taxpayers' bookkeeping, and lack of cooperation in providing data and documents. The tax audit adjustments are also complicated by regulatory frameworks, by organization and human resource issues, and by the knowledge levels of tax auditors.

How do tax auditors overcome these difficulties? The second research question asks interviewees to shed light on possible audit strategies. Respondents mention that they received most assistance from: appropriate regulations aimed at assisting tax auditors, such as Article 18 paragraph 3 of the Income Tax Law and domestic regulations; legal documents, contracts, or agreements entered into among affiliated enterprises; and the OECD transfer pricing guidelines.

The findings from this study should assist policy makers in the Head Office of the Directorate General of Taxes to improve the quality of transfer pricing audit. In terms of better management of human resources including the rotation system for tax auditors; the right man in the right place principle might need to be applied. Those assigned to the large taxpayer and special regional offices should have the highest level of knowledge and expertise. Further current regulations for transfer pricing cases need to be amended especially those related to the time limit for completion of a tax refund audit . Moreover, the number of databases of comparables

should be increased, and they should be available more widely than in the Head Office, so that tax auditors can access them readily during the audit process. Further, the level of expertise dedicated to transfer pricing cases should be higher in the organizational structure.

The head of the district tax office, in dealing with transfer pricing cases derived from intangible properties, should adopt a strong leadership role in discussions with tax auditors and, as the last filter in audits, provide reviews and make the necessary corrections for the improvement of audit. Lastly, tax auditors and account representatives who do not have enough experience in auditing transfer pricing cases derived from intangible property rights might use the outcomes of this study as a guide for dealing with those cases.

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Appendix 1
Indicative Questions for Semi-structured Interviews with the Tax Auditors

Indicative Questions

1. How long have you been working as a tax auditor for the Indonesian tax office?
2. Could you explain, in general, what your main duties are?
3. Could you explain your academic background?
4. What are some the most challenging factors in conducting tax audits?
 - Technical complexities related to transfer pricing problems emanating from intangible property transactions?
 - Complexities related to transfer pricing regulations?
 - Workloads and experience with tax audit adjustments?
 - Data accessibility?
5. What steps did you take to resolve the tax audit difficulties associated with audit of intangible properties?
6. Did you conduct a comparable transaction analysis? If so, what steps were taken by you in finding comparable transactions for intangible properties?
7. Did you consider the guidance offered in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations for tax auditing purposes?